CHASE

International Finance

Vol. XVIII, No. 11
May 23, 1983

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1A 5/26/83

The U.K. Election and Downside Risk for Sterling

British Prime Minister Thatcher's decision to call an early election for June 9 obviously was not made lightly. The Conservatives' ambitious policy program of expenditure cuts, tax reductions, and monetary restraint took much longer than expected to implement and has been disappointingly slow to take effect. Only in the past several months have the painful policies of the last four years begun to make headway.

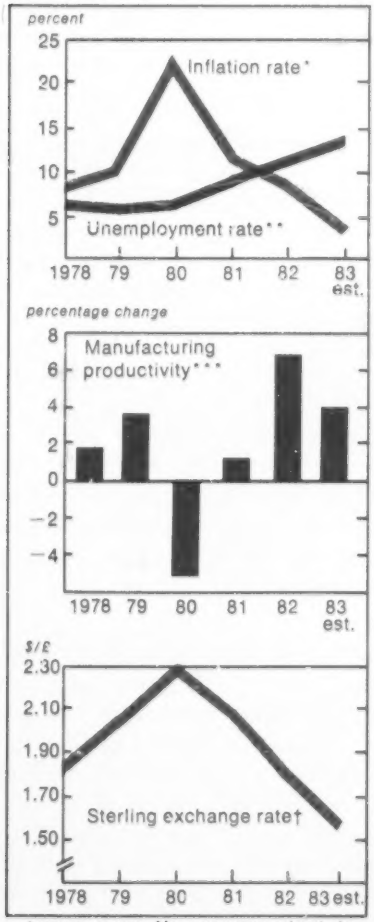
The British economy is now rebounding from the recession, and the business community has grown markedly more optimistic. The underlying rise in unemployment has become quite small. And most important, inflation has slowed to about 4%—its lowest level since the mid-1960s. But while the opinion polls have consistently shown the Conservatives well ahead of the other parties, there have been gnawing doubts over how long that position can be maintained. With the possibility that the economic indicators could worsen before 1984—inflation, in particular, is almost certain to reaccelerate from its current level—it made good sense to call an election now.

The decision, however, is not without risk. Election day is still some time away, and previous campaigns have seen significant swings in voter sentiment. There is a possibility that the electorate will decide that the price of Mrs. Thatcher's success in taming inflation and boosting productivity has been too high to warrant another five years of her leadership.

A Thatcher loss would likely mean a setback for the British economy in the long run—and for the pound almost immediately. All signs are that should the Labor Party win the election, it would adopt radically different policies in such areas as public spending, taxation, nationalization of industries, exchange controls, and British membership in the EEC. This would almost certainly cause sterling to come under heavy selling pressure. A hung parliament—perhaps with an alliance of the Social Democrats and Liberals holding the balance of power—would result in a similar, though less-pronounced, selloff of the pound.

A win by Mrs. Thatcher, on the other hand, would strengthen sterling, although not as much as casual comparisons with the aftermath of the 1979 election might suggest. At that time, oil prices were rising sharply; now they are flat and show some signs of falling. Also, in 1979, Mrs. Thatcher offered a startling break with the previous government's attitudes; this certainly would not happen this time around. Moreover, the need to limit inflation via exceptionally tough monetary policy has virtually disappeared. All in all, the foreign-exchange markets would probably react to a Thatcher reelection with relative calm.

Selected U.K. economic indicators



*year over year, May consumer price index
**May rate, old definition
***second quarter over second quarter
†average of daily figures for May

© 1983—Economics Group, The Chase Manhattan Bank, N.A.

Ireland's stringent policies beginning to show results.

The tough policies that a new budget imposed on the Irish economy in February are now beginning to pay off. At a cost of virtually no growth in real GDP, the current-account deficit is being steadily reduced. Latest forecasts from the Department of Finance point to a shortfall of about 350 million pounds—some 3% of GDP, compared with 8.5% in 1982 and 14.5% in 1981. The year-on-year inflation rate was 12.5% in the first quarter of 1983 versus an average rate of 17.1% last year. Public-sector pay negotiations are now in progress and the prime minister has already brought strong pressure to bear on the unions in an attempt to bring wage increases down to average European levels. If world economic activity picks up during the next twelve months and thus expands Ireland's export markets, the country's prospects could be markedly improved by the end of 1984.

Italy still in need of an upturn, slower inflation, and a lower budget deficit.

Although output appears to have bottomed out or started to rise in much of the rest of Europe, Italy's recession continues. Industrial output fell by 1.5% in March—the fourth consecutive monthly decline—bringing the year-on-year drop to 9.2%. Survey data on industrialists' inventories and orders also show no signs of an upturn. However, inflation—although currently at an annual rate of over 16% —appears set to come down. Moreover, the trade deficit narrowed sharply in March, bringing the first quarter shortfall to some 4.1 trillion lira, compared with 5.6 trillion in the same quarter a year earlier. These developments, combined with the relative strength of the Italian lira following the EMS realignment in March, have allowed the Bank of Italy to reduce the discount rate by one percentage point to 17%. No fiscal policy initiatives are expected to take place before the end of June when the country faces general elections. And the new government—again likely to be a coalition—will still face the daunting task of reducing inflation and the public-sector deficit (now over 15% of GDP) without further postponing an upturn, now expected for the latter part of 1983.

Some economic progress in Denmark.

Despite still-serious problems, the Danes are becoming more optimistic about their country's economic prospects. The Economics Ministry's annual survey, published in April, has revised its forecasts for the 1983 budget deficit down to 56 billion kroner from 69 billion kroner, with further improvements projected for 1984. GDP growth is expected to pick up through this year, resulting in a year-on-year increase of 1.5%. At the same time, the current-account deficit is expected to fall to 14.5 billion kroner from 20 billion kroner in 1982. Wage increases will be held to about 6% in 1983 and the annual inflation rate could fall to the same level by mid-year. This optimism is being reflected in interest rates and bond prices. The official discount rate has been reduced to 7.5%—the lowest rate since 1975—and most bank lending rates have been cut by three percentage points. Bond prices have soared and effective yields have fallen from 22% at the end of last year to about 15% today, while stock prices have risen by 32%. All this represents a striking turnaround from the recent past. But the Danes are well aware that the economy must continue on the same trend for several years before they can begin to reduce their huge overseas debt, which—even on a net basis—now equals 33% of GDP.

Bolivar devaluation adds to the problems of the Netherlands Antilles.

The economy of the Netherlands Antilles—already hard hit by world recession and the slump in world oil demand—received another blow from the February devaluation of the Venezuelan bolivar. The Venezuelan devaluation nearly doubled the U.S.-dollar cost of travel for Venezuelan tourists. As a result, their visits to nearby Curaçao and Aruba—two of the six islands that make up the Netherlands Antilles—have come almost to a halt, dramatically affecting hotel and restaurant business, retail trade, and airline revenues. In addition to tourism, the economy of the Antilles is heavily dependent on offshore banking and on oil refining and shipping—sectors that have suffered declines as a result of the global recession and weak world oil markets. These trends suggest a somewhat gloomy business outlook in 1983 for this federation of islands. However, development aid from the government of the Netherlands should help soften the downturn.

Brazil showing a better trade balance in a slow economy.

Despite the continuing problems of economic adjustment and inadequate external liquidity, Brazil is making some headway in improving its foreign trade situation. A strong $606-million surplus in April pushed the trade balance for the first four months of 1983 into the black by $1.45 billion—a striking increase over the scant $70-million surplus for the comparable four-month period in 1982. The April trade performance was partly the result of stepped-up devaluations of the cruzeiro and improved agricultural sales, which led to a 17% year-over-year increase in exports earnings. In the same month, imports fell 21% owing to the general slowdown of the economy and reduced purchases of foreign petroleum. Brazil still faces a number of economic difficulties: Because of demand-restraining policies, industrial production is at low levels; unemployment remains troublesome; and inflation is running at more than 100% per annum. Nevertheless, the Brazilian authorities have focused on the attainment of a substantial trade surplus this year as a key goal. Thus, fiscal and monetary policies are likely to be increasingly directed in that direction.

Despite strict strategy, Taiwan's budget will still show sizable shortfall.

By the end of this month, Taiwan is expected to approve a tight budget for fiscal 1983-84, which begins July 1, in an effort to help restrain inflation. Total state spending will fall by 4.5%—the first decline in Taiwan's history. Even so the deficit is projected to rise 19% from fiscal 1982-83 to 34 billion New Taiwan dollars, as tax revenues are scheduled to fall 11.4% and total revenues by 6.6% following tariff reductions. As large as the deficit is, it may be difficult for Taiwan to achieve its budgetary targets, since these budget projections are based on an optimistic 5.5% real growth assumption. As a result, the realized deficit may be even larger than that forecast.

Oil-market slump slows Singapore growth, but government spending helps pick up the slack.

Real economic growth in Singapore slowed to 6.3% last year from 9.9% in 1981, and will probably decelerate further this year to around 4%-5%. The world recession has weakened the market for Singapore's manufactured exports, particularly consumer electronics. However, a more important depressant of economic activity has been the troubled oil market. The oil-refinery industry—Singapore's largest in terms of investment and sales—is shrinking rapidly because of the downturn in world oil demand and because of efforts by Indonesia to build up its own refineries. Other industries have been affected as well, including oil-rig manufacturing and oil-exploration services. The Singapore slowdown would be even more severe were it not for an expansionary government budget, with large outlays for housing and education. Late this year, ground will be broken for a new subway system and this is expected help to stimulate the economy in 1984 and 1985.

Ivory Coast: success in reducing inflation, budget deficit; current account still a problem.

Despite significant policy-directed internal adjustments in its economy, the Ivory Coast is expected to show only a marginal improvement in its external accounts. An austerity program under IMF supervision succeeded both in bringing the rate of inflation down well into the single digits and in narrowing the budget deficit to 8.9% of GDP in 1982 from 12.8% in 1980. This year, the fully-functioning Espoir oil field is projected to generate fiscal revenues to reduce the budgetary deficit further to 6.2% of GDP. Oil-sector activity should also help reverse the economic decline of the past two years to real growth of around 2%-3%. A substantial turnaround in the external sector, however, seems destined to be postponed once again. The declining prices for the country's main exports of cocoa and coffee that had depressed export receipts since 1980 appear to be rebounding. But this year's higher prices will be offset by sharply lower production owing to widespread drought and bush fires. Thus, despite a recession-induced decrease in the value of imports, the current account—aggravated by rising interest payments on the foreign debt—can be expected to remain nearly $1 billion in deficit.

Shift in Bank Asset Portfolios

The coincidence of a major slowdown in corporate loan demand and the huge inflow of funds into money-market deposit accounts (MMDAs) has forced dramatic changes in commercial-bank asset portfolios over the past several months. Since mid-1982, there has been a substantial reliquification of bank assets and an impressive shift away from commercial and industrial (C&I) loans in favor of U.S. Treasury securities. The current outlook suggests this trend is not likely to be reversed in the near future and could step up competitive bank lending pressures before the year is out.

Growth over the last six months in commercial-bank C&I loans slowed to an annual rate of 2%—compared with 16% in the first half of 1982—largely as a result of corporate efforts to clean up battered balance sheets. During much of 1982, firms were stuck with slack sales and unwanted inventories, forcing them to borrow short-term funds from banks or the commercial-paper market. But thanks to the sharp inventory liquidation that began late last year and other changes in the economy, the heavy reliance on short-term debt has been greatly alleviated. The marked decline in corporate bond yields over the last few months has encouraged many firms to fund out their debt. In addition, the prolonged stock-market rally since late last summer has enabled many firms to pay down much of their debt and obtain an increased portion of their funds through equity financing. The result has been a striking decline in the demand for bank credit.

At the same time, bank deposits have climbed sharply. Since last July, deposits have risen 13%—largely as a result of the introduction of MMDAs last December. Because this tremendous inflow of funds has come in a period of slack loan demand, banks have had to find alternative investments. The favorite—at least for the time being and particularly for the regional banks—appears to be U.S. government securities. Total bank holdings of Treasury securities, which grew at only a 2% rate in the first half of 1982, have soared at a 75% rate since July. The amount of cash on hand has also gone up significantly since mid-1982.

This shift in relative asset holdings by commercial banks should continue through 1983. With slow growth expected in business investment, an optimistic outlook for corporate profits and retained earnings, and continued refinancing by firms that are making up for years of depressed stock and bond prices, the prospects for growth in commercial-bank C&I lending are bleak. This is likely to encourage increased competition among the banks for corporate loans. At the same time, banks can be expected to be on the lookout for other alternative assets for their portfolios.

Robert S. Smith

Consumers Coming on Board

On the surface, the 2.5% rate of real growth reported for the first quarter makes the U.S. economic recovery look pretty anemic. In fact, the details of the data are quite encouraging. Along with more-recent information, they show important improvement on two counts: Major progress has been made in bringing down business inventories that had been much too high in relation to sales; and consumer spending (about two-thirds of GNP) is showing signs of renewed vigor.

It has been obvious for some time that the balance between developments in business inventories and consumer spending would determine the degree and shape of the early stages of this economic recovery. Trends in other sectors of the economy are pretty well established for the time being. Residential construction and military spending are strong. But they are a quite small part of the total. Three much larger sectors—capital spending, exports, and non-military government purchases—are flat-to-down, and likely to remain so at least through most of 1983. These three weak sectors account for three times the economic activity represented by house construction and military purchases. Hence, the key question has been: Could consumer spending grow in spite of income losses resulting from inventory reduction and weakness elsewhere in the economy? It was touch and go through most of the winter. With the coming of spring, however, the news brightened a lot.

Business inventories were reduced by a record amount in the fourth quarter of 1982, and by nearly as much in the first quarter of this year. By the end of March, the inventory-sales ratio had been cut from 1.55 last October to a much more comfortable 1.45. Reductions are continuing in some industries. But more and more companies now find their inventories insufficient to support the current rate of sales. So they are lengthening the workweek and calling back laid-off employees. Over March and April, 450,000 workers were added to non-farm payrolls. The average workweek in manufacturing rose by a full hour between February and April. And in April, industrial production was up by a huge 2.1%. Wage and salary income rose by 0.6% in March and 0.8% in April.

Consumers have responded enthusiastically to these improvements in their economic circumstances. After months of stagnation, retail sales grew by 1.7% in March and 1.6% in April. Furthermore, there are signs of additional sales gains to come. The index of consumer sentiment published by the Survey Research Center at the University of Michigan shot up in both March and April, reaching its highest level in several years.

It is unlikely that these developments presage an outright consumer boom. The high unemployment rate—still over 10% and expected to improve only slowly—will continue to serve as a damper on sales. But the trend has clearly turned up. The 10% cut in income taxes scheduled for July should help it along.

Richard W. Everett

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF PAYMENTS					MONEY AND BANKING						COUNTRIES
											12-month changes						
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate△ May 18, 1983	exchange rate in U.S. dollars	current monetary conditions	
Austria	No significant policy change likely from expected Socialist-Liberal coalition.	Dec.	— 6%	65.8	0	Mar.	5,048	+ 4%	3.3	0	Stronger demand in Germany contributing to Austrian current-account surplus.	Mar.	+ 3%	Mar.	+ 9%	3.75%	.0576	Schilling remains informally linked to DM.	Austria
Belgium	Private consumption forecast to decline again this year, but export and investment prospects improve.	Jan.	+ 1%	85.1*	—1.9%	Mar.	4,826	+21%	1.1	0	Current account showed provisional deficit of 122 billion francs in 1982.	Apr.	+ 8%	Dec.	+12%	9.50%	.0204	Interest rates fall.	Belgium
Britain	Consumer demand remains buoyant and some 2% GDP growth is expected this year.	Feb.	+ 3%	505.8	—2.0%	Mar.	11,423	—21%	1.4	0	Current account showed a 287-million pound surplus in 1983 first quarter.	Mar.	+ 5%	Feb.	+11%	10.06%	1.5595	No rise in interest rates expected before election.	Britain
Denmark	Real growth of 1.5% expected this year.	Dec.	+ 4%	55.9	—0.2%	Mar.	2,499	+19%	1.8	0	March's trade performance produced first-quarter deficit of kr518 million.	Mar.	+ 8%	Dec.	+11%	8.50%	.1141	Interest rates now at lowest level since 1975.	Denmark
Finland	Growth is expected to reach 2% this year, double last year's figure.	Dec.	— 3%	48.3	+1.4%	Mar.	1,127	—27%	1.0	8	First quarter 1983 showed a FMK 588-million trade surplus.	Apr.	+ 8%	Nov.	+18%	8.50%	.1842	Money market conditions have eased a little.	Finland
France	Tough austerity program designed to cut real domestic demand by 2%; unemployment set to rise.	Feb.	+ 1%	568.5	+0.3%	Feb.	17,112	—17%	1.8	0	Trade deficit expected to improve sharply after poor first quarter.	Mar.	+ 9%	Jan.	+11%	9.50%	.1353	Interest rates hold steady.	France
Germany	GDP resumes positive growth in first quarter, but recovery remains fragile.	Mar.	— 8%	659.7*	—1.1%	Mar.	49,840	+21%	4.0	0	Improved terms of trade forecast to raise current-account surplus.	Apr.	+ 3%	Feb.	+10%	4.00%	.4068	Interest rates bottomed out for time being.	Germany
Greece	Economy remained flat last year despite expansionary policies; inflation remains over 20%.	Nov.	— 6%	38.0	—0.7%	Mar.	917	— 3%	1.1	0	Current-account deficit expected to rise from last year's $1.9 billion.	Feb.	+21%	Nov.	+21%	20.50%	.0119	Credit expansion remains high, especially to public sector.	Greece
Iceland	Fish catches down, export markets depressed; GDP to fall by 2.7% in 1983 after 3.5% decline in 1982.	n.a.	n.a.	2.8	+1.7%	Mar.	129	—37%	2.4	23	Current-account deficit to narrow this year but will still reach 6% of GNP.	Feb.	+68%	Nov.	+18%	28.00%	.0457	Inflation accelerating again; will reach 70% in 1983.	Iceland
Italy	Recession continues as investment weakens; election scheduled for June 26-27.	Mar.	— 9%	350.6	—0.2%	Mar.	14,219	— 4%	2.1	0	Trade deficit set to improve owing to recovery in rest of Europe.	Apr.	+17%	Oct.	+15%	17.00%	.00068	Interest rates decline moderately.	Italy
Netherlands	Government imposes further spending cuts in order to reduce growing public-sector deficit.	Feb.	— 2%	137.9*	—0.8%	Mar.	10,835	+17%	2.0	0	Gas export revenues decline, reducing trade surplus.	Apr.	+ 3%	Jan.	+10%	4.50%	.3617	Rates raised as guilder weakens after EMS realignment.	Netherlands
Norway	With oil prices still weak, GDP will remain flat this year.	Feb.	+ 1%	55.6	+0.8%	Mar.	5,885	— 3%	4.8	0	Trade remains in a healthy surplus.	Apr.	+ 9%	Nov.	+12%	9.00%	.1407	New proposals will allow small number of foreign banks.	Norway
Portugal	April election clears path for new economic measure.	Aug.	+12%	23.5**	+5.5%	Feb.	493	+29%	0.7	3	Republic raising $300-million syndicated loan.	Jan.	+21%	Nov.	+15%	19.00%	.0101	M2 growth rose to 27.1% in November.	Portugal
Spain	Proposed 1983 budget deficit of 1,100 billion pesetas, lower than previously expected.	Nov.	— 1%	183.7	+0.3%	Feb.	7,165	—29%	2.9	0	Current-account deficit in 1982 declined to $3.9 billion.	Mar.	+13%	Dec.	+11%	8.00%	.0073	March M3 growth was 15.3%; 1983 target is 13%.	Spain
Sweden	New official forecasts point to 1.8% rise in GNP this year.	Jan.	+ 2%	111.5	—0.7%	Mar.	3,455	+ 1%	1.5	0	Huge March surplus puts 1st qtr. trade balance kr2.7 billion in black.	Mar.	+ 8%	Dec.	+10%	9.00%	.1337	Discount rate cut to 8.5% on April 8.	Sweden
Switzerland	No growth expected this year.	Dec.	— 9%	99.4	+1.9%	Mar.	13,937	+ 9%	5.7	0	First quarter 1983 recorded trade deficit of SF2.4 billion.	Apr.	+ 5%	Mar.	+ 6%	4.00%	.4895	Monetary conditions tightened.	Switzerland
Canada	Recovery given boost by recentiy announced federal budget favoring private sector.	Feb.	— 3%	283.6*	—4.8%	Mar.	3,489	+60%	0.8	0	Current-account surplus will narrow as imports rebound faster than exports.	Mar.	+ 7%	Feb.	+10%	9.27%	.8126	Sharp inflation deceleration brings hopes of lower rates.	Canada
United States	Consumer spending picks up, leading economy into stronger recovery.	Apr.	+ 2%	3,059.3*	—1.7%	Mar.	23,123	+23%	1.1	0	Exports continue to slump, non-oil imports rise; trade deficit widening.	Mar.	+ 4%	Mar.	+11%	8.50%	—	M1 growth slowed in April, likely to reaccelerate.	United States

*1982 **1980 △most recently reported

BEST AVAILABLE COPY

World Interest Rates

market rates as of May 18, 1983; bond yields as of May 13, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.27	10.063 intervention rate	9.50	9.50	4.00	17.00 penalty rate 20.00	4.50	4.00	5.50
Day-to-Day Money	8.625 May 19	10.75	10.00	7.75	12.25	5.00	18.00	4.75	2.75 1-month Eurc-Swiss fr. rate	6.063
Treasury Bills 91-day, Middle Rates	8.10	9.05	9.875	10.00	n. a.	n. a.	17.10 163 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.20 finance paper 15% tax w/h	9.451	9.40 Certified	12.563 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.45	9.10 15% tax w/h	9.859	9.40 Certified	not traded	5.35	18.95	no market	4.625	no market
Government Bonds Long-term, new and old issues, average yield	10.60	11.50	10.48	10.05	13.705	7.83	18.29	8.28	4.40	7.04
Industrial Bonds prime, long-term, new and old issues, average yield	11.25 Aa Industrials	12.125	12.19	12.23	14.81	7.75	17.96	8.66	5.72	6.46
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.00	14.55	8.00	18.75 ⅛ qtrly fee on outstdng.	7.50	7.50	6.00
Bank Time Deposits 3-month	8.125 Cert. of Dep.	9.29	10.25	9.95	12.625	5.10	11.50	5.50 large deposits	3.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.063	9.375	10.375	no market	13.75	5.0625	no market	5.688	4.50	6.313
Exchange Rates—in U.S.$ rates floating against the $	—	.8122	1.562	.0204	.1350	.4066	.0007	.3616	.4885	.0043
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.246 *D*	1.204 *D*	1.336 *D*	4.741 *D*	4.230 *P*	7.028 *D*	3.540 *P*	4.831 *P*	2.793 *P*

Eurodollar Deposits
(London, interbank, bid)
May 19

7-day	8.813
1-month	8.875
3-month	9.00
6-month	9.063

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.436
U.S.-Canada Treasury Bills	−0.383
U.S.-Canada Finance Co. Paper	−0.328
Eurodollars-U.K. Local Auth. Deposits	+0.142

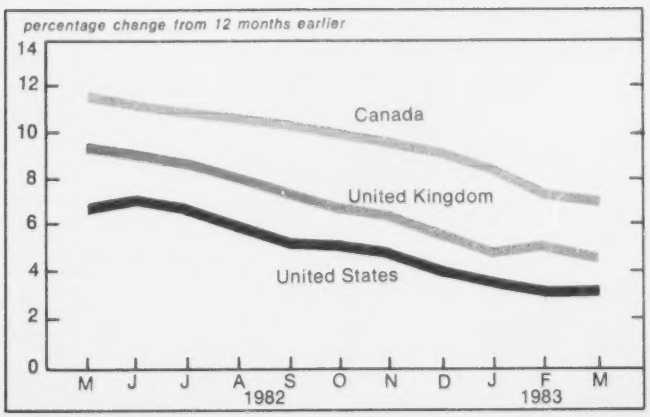
Eurobonds
(average yield on recent straight debt issues)

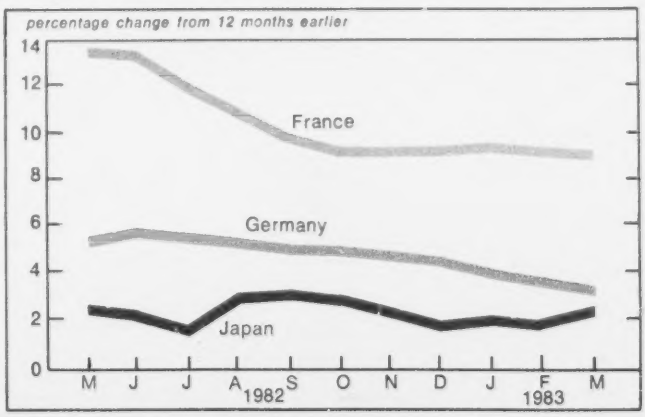
U.S. Dollar Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.75
DM Bonds	
7 yrs. and under	7.25
Over 7 yrs.	7.50

Gold Price
London afternoon fixing
442.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.

Consumer price trends in selected industrial countries





BEST AVAILABLE COPY

Can Sterilized Intervention Work?

Exchange-rate volatility is certain to place high on the agenda of the economic summit in Williamsburg at the end of this month. Indeed, some agreement toward increased intervention by the major Western central banks aimed at dampening the violent exchange-rate fluctuations of the last few years may well emerge from that meeting. At first blush, intervention has intuitive appeal as a means of stabilizing exchange rates. In practice, however, it introduces a paradox that is difficult to resolve: Unless the intervening central banks also take offsetting monetary actions, they effectively give up control over their own domestic monetary policies. But if they do take these actions, the intervention may be fruitless.

Much of the current debate among economists, central bankers, and politicians on the "effectiveness" of foreign-exchange intervention implicitly assumes that the monetary policies of each of the participating players do not change. That is, the domestic monetary effects of the intervention are "sterilized" by offsetting monetary expansion or contraction, to enable each country to pursue the combination of interest rates and monetary growth rates that it would have followed in the absence of intervention.

There is good reason to believe, however, that exchange-rate fluctuations cannot be stabilized by sterilized intervention—at least for any period that is relevant for practical policymaking. This can be seen from a brief review of some basic principles.

The rationale for intervention

Problems arise from currency fluctuations because the prices of real goods and labor rarely adjust as quickly as the prices of financial assets. Consequently, exchange-rate fluctuations lead to changes in relative prices and relative labor costs either between one country and another or between one industry that produces tradable goods and another industry that produces only non-tradable goods. This then influences decisions on where and what to produce, and thus, affects output and employment—not always in the desired way.

Still, it is necessary to distinguish between exchange-rate fluctuations that occur in the short run —say within a day or a week—and medium-term currency swings that can last from several months to three years. Short-run exchange-rate fluctuations are not likely to affect business decisions regarding investment, production, or pricing and are therefore unlikely to have any material effect on the real economy. Of course, such short-run movements heighten financial risk and thus raise the cost of doing business, which may lead to some reductions in output. But the effect is small. Medium-term fluctuations, on the other hand, do affect business decisions.

Because of this, economists and central bankers have sought ways to eliminate, or at least minimize, exchange-rate fluctuations. On the surface, intervention—defined as the purchase or sale of foreign exchange in the open market by the central bank or monetary authority—appears to be an appealing means of stabilizing an exchange rate. It seems analogous to stabilizing the price of any commodity: buy for stockbuilding when the price is falling and sell from stocks when the price is going up.

The analogy, however, is incomplete because of the tight links between the foreign-exchange and money markets. When a central bank sells foreign exchange but does nothing else, it reduces the stock of money—strictly speaking, the stock of "high-powered" or "base" money. This reduces liquidity and tends to raise interest rates. Symmetrically, when a central bank buys foreign exchange against its own currency but takes no offsetting action, it raises the stock of base money in its economy, which increases liquidity and tends to reduce interest rates.

Thus, by stabilizing exchange rates without taking offsetting monetary action, central banks lose independent control of their own money stock and level of interest rates. In fact, it is this implicit subservience of monetary policy to an exchange-rate target that provides the adjustment mechanism by which systems of fixed exchange rates survive. The tightening of liquidity that results from intervention to support an exchange rate under downward pressure ultimately removes that downward pressure.

To the extent that foreign-exchange intervention compromises either interest-rate or money-growth targets, a central bank will seek to offset or "sterilize" these effects. For example, a central bank selling foreign exchange to alleviate downward pressure on its currency would foster a lower money stock and higher interest rates. If it sees this as undesirable, it will either buy securities in the domestic financial market or seek to restore domestic liquidity in some other way, perhaps by lending more to the banking system. Conversely, a central bank intervening to prevent an appreciation of its own currency will frequently take offsetting contractive action to ensure that domestic liquidity remains unchanged.

The problem is that sterilized intervention generally does not stabilize exchange rates. In theory, there is a special set of conditions under which sterilized intervention will have an effect. However, those conditions either: (1) apply only in the very short run —when exchange rate fluctuations do the least harm or good for the economy, or (2) are empirically unrecognizable in any longer-run time frame relevant to central-bank policy decisions.

To understand why this is so, consider the example

Can Sterilized Intervention Work? *(continued from page 7)*

of a central bank that sterilizes the effects of intervention to stabilize interest rates. Arbitrage ensures that the forward premium or discount of one currency against another will closely approximate the interest-rate differential between the two countries for instruments of equal maturity and risk. This relationship is known as interest parity. If the central bank fixes domestic interest rates, then—for a given level of foreign interest rates—the forward premium or discount is determined. It follows that any attempt to change the spot rate will provide profits to arbitrageurs unless the forward exchange rate is also altered.

Under "normal" conditions, the forward rate represents the market's "best guess" of the future level of the spot rate. This is determined by the information available to the market at the time the forward rate is negotiated—including information on actual and expected inflation rates, trade balances, actual and expected monetary policy, and anything else that, in the market's eyes, affects exchange rates. If all of this information is available to all market participants, then—unless market participants are extremely risk averse—the equilibrium forward rate is equal to the expected value of the future spot rate for currencies of similar risk characteristics. If this were not the case, speculators could profit by buying or selling forward until the forward rate adjusted to the market's expectation of the future spot rate.

Because of the interest-parity relationship, the key to successful sterilized exchange-rate stabilization is the central bank's ability to influence the forward rate. There are only two conditions under which this can be done: (1) when, under extraordinary circumstances, the forward rate is not equal to the market's expectation of the future spot; and (2) when the central bank has superior information to the market and thus knows in advance of the market the direction in which the forward rate will change.

The first case prevails when there is an insufficiency of speculators. This may occur in the extreme short run when all available information has not had time to be evaluated by the market or when the difference between the forward rate and the expected future spot rate is so small that the risk for the potential speculator outweighs the expected profit. It is also possible that insufficient longer-run speculation might occur because market operators are extremely risk-averse. In such a case, the forward rate would differ from the expected future spot rate because market participants are unwilling to act on their "best guess." Then the central bank could influence the forward rate by intervention.

The second situation when stabilization is successful occurs when the central bank has information in advance of the market. In this case the central bank can tolerate a temporary disequilibrium in the exchange and money markets, knowing that the forward rate will move to its equilibrium level once the information available to the market is amended. This is not a frequent occurrence, however. A number of academic studies have concluded that central banks are not often successful in outguessing the market.

In the first situation, the problem is that, in practice, it is impossible to determine ahead of time whether a change in the forward rate is due to an insufficiency of speculation or to a change in the market's information. It is, therefore, impossible for the central bank to decide whether its intervention will stabilize the rate by moving the forward rate toward the expected future spot rate, or whether it will merely act against the market. The latter outcome would, in effect, provide a gift to speculators and arbitragers, and ultimately destabilize the spot rate by exhausting central-bank reserves. As for the second situation, it occurs too infrequently to be of major importance. The overall conclusion is that sterilized intervention will not generally stabilize exchange rates.

Which kind of instability?

Exchange rates can be stabilized, of course, if central banks are willing to subordinate their monetary policy to an exchange-rate target. They would then no longer commit themselves to stabilizing domestic interest rates, nor would they have the freedom to choose any path for the rate of growth of the money supply. Under such conditions, however, unpredictability of information would show up as instability in interest rates rather than in exchange rates. Since the interest rate represents a price as much as the exchange rate does, it is not immediately clear that interest-rate instability is preferable to exchange-rate instability. In any event, post-1973 history has shown that most governments are not willing to give up control over interest rates and money-supply growth, and thus will ultimately prefer exchange-rate adjustments over interest-rate adjustments.

The real key to greater financial stability—be it in interest or exchange rates—is greater predictability of information. Of course, certain random shocks—such as political crises, oil crises, or natural disasters—cannot be avoided. But much of the recent instability has been caused by shifts in government policy and by the market's necessarily imperfect understanding of how policymakers are likely to react to certain economic events. Greater financial stability thus requires, among other things, a steadier and more predictable set of government policies. In Western democracies, this, in turn, requires a steadier and more predictable set of electoral preferences.

George de Nemeskeri-Kiss
Chase London